

CPSS-IOSCO

Consultative report on Recovery and resolution of financial market infrastructures

Clearstream's response to the consultative reports

28 September 2012

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Clearstream Banking AG, Frankfurt and Clearstream Banking S.A., Luxembourg (jointly referred to as Clearstream) appreciate the opportunity to comment on the public consultation on the "Recovery and resolution of financial market infrastructures" issued by CPSS-IOSCO. As a wholly owned subsidiary of Deutsche Börse Group, Clearstream is one of the world's leading suppliers of post-trading services including settlement, safekeeping, and administration of securities, Clearstream welcomes the objective to harmonize at a global-level the adoption of effective strategies, rules and procedures to enable FMIs to recover from financial stress.

The settlement of market transactions, the custody of securities and the management of collateral are Clearstream's most important fields of activity. In this environment Clearstream provides two fundamental services:

- International Central Securities Depository (ICSD): As an ICSD it has, over a period of over 40 years, developed a strong position in the international fixed income market. It handles the clearing, settlement and safekeeping of international securities and offers its customers the possibility to use Clearstream Banking as a single point of access for the settlement and custody of internationally traded bonds and equities across 54 markets.
- Central Securities Depository (CSD) for German domestic securities.

(I)CSDs have proven their resilience during the financial crisis, while playing a stabilizing role on the financial markets, in particular in facilitating the movement of collateral between counterparties at a time of severe liquidity stress and in ensuring the availability of global settlement liquidity to the financial centre. This has been a test for infrastructures throughout the world which has proven the appropriate implementation of sound and safe risk management procedures and global best-practice standards.

Considering that as far as CSDs are concerned, we are not aware of any CSD having had to be resolved in recent history, and so there is no precedent of using resolution tools for closing down a CSD while maintaining the continuity of its critical operations. It needs to be ensured that newly introduced international rules and the proposed recovery and resolution do not affect the safety, efficiency and services innovation of the current post-trading arrangements.

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Comments on the Consultative report on the Recovery and resolution of financial market infrastructures

1. General comments

Future international standards for the recovery and resolution of FMIs should contain CSD-specific guidance.

As commented in previous exercises, once more the approach of this consultative report is very CCP -centric, which in general terms is less adapted to the functions and risks undertaken by CSDs.

Given the objective of ensuring the continuity of the critical functions of a market infrastructure, it seems to us essential that the rules should be adapted to the requirements of the particular function in question. Defining clearly appropriate rules specifically adapted to the particular functions provided by ICSDs and CSDs is prerequisite to the effectiveness of this exercise, just as defining rules appropriate to the particular functions of CCPs and Trade Repositories is critical to the effectiveness of the exercise in respect of the particular functions that those infrastructures provide.

We fully understand the need for detailed plans to take account of any functions performed by CSDs under a banking licence. However, that is no reason to treat them in the same way as CCPs for recovery or resolution purposes since the functions provided by CSDs, the continuity of which the Consultative Report seeks to ensure are quite different to and no less essential than those provided by a CCP.

CSD-specific requirements (as opposed to those of other FMIs, and particularly CCPs), would serve to highlight more in detail the differences between CSDs and other forms of FMIs.

Moreover, we recommend that the CPSS-IOSCO report should make it clear that CSDs (or other FMIs) which are licensed as banks should be treated as CSDs (rather than as banks) for resolution purposes, due to their central and systemic role in the market(s) they serve. As a consequence, we believe that emphasis should be placed on solid recovery plans for CSDs, so that resolution tools are even less likely to ever be used in the future.

Avoiding inconsistency due to double regulation

This initiative dwells on the work already achieved in relation to recovery and resolution by the CPSS-IOSCO Principles and the FSB Key Attributes. However, the scope, approach and target institutions on these two plans are the same. Given that CSDs and other FMIs are expected to apply both the Principles and the Key Attributes, we believe it is important to clarify which

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terminology should be used and which requirements apply to CSDs only in order to avoid duplication and inconsistencies.

Hence a single set of standards for the recovery and resolution of CSDs would be preferable to overlapping standards.

Resolution of a CSD should take into account the Settlement Finality rules

It should be stressed that CSD resolution regimes should ensure that legal arrangements aimed to guarantee settlement finality (e.g. the EU Settlement Finality Directive) are respected throughout the resolution process. Transactions already processed for settlement should be irrevocable unless both counterparties agree to a bilateral cancellation.

The consultative report focuses on four resolution tools, namely (1) bail-in, (2) transfer to a third party, (3) bridge institution, and (4) public administration/conservatorship. In general terms the last option is the better adapted for CSDs.

Approach for CSDs that take on credit risk

What qualitative or quantitative indicators of non-viability should be used in determining the trigger for resolution for different types of FMI?

The taking on of credit risk creates a potential loss or liquidity event for an (I)CSD as an FMI. It is therefore appropriate to define the indicators that would trigger recovery and resolution actions. Nonetheless, the individual risk profile of the FMI in question has a significant bearing on the qualitative and quantitative triggers that could be considered relevant. In Clearstream's view, the Committee's recommendations on such indicators should require the definition of a framework that is adapted to the situation of the FMI in question and the markets and customers that it serves rather than to its classification as an FMI.

The indicators for resolution and for recovery need to be treated quite distinctly. Clearstream believes that in principle there is only one fundamental indicator that can act as a trigger for the resolution of a CSD; that it can no longer meet its obligations as they fall due or is at imminent and evident risk of being unable to do so. We believe that the use of any leading indicator as a trigger for concrete resolution action should be avoided. A leading indicator of insolvency as a trigger for resolution (as opposed to recovery) action would treat both shareholders and depositors inequitably and would be open to the risk of abuse. This is not merely a constitutional concern; the mere potential for the resolution of a solvent FMI could drag the perceived credit worthiness of the FMI and, paradoxically, make its failure more rather than less likely. The use of leading indicators as triggers for resolution action would, in other words, be strongly pro-cyclical.

We would like to single out one particularly important indicator of potential loss to an FMI for consideration; the imminent failure of a large financial institution. In cases where supervisory authorities are aware of the impending failure of a financial institution or financial institutions to whom FMIs may be exposed, consideration should be given to the inclusion of

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system critical FMIs into the default preparations of the relevant authorities. Clearstream believes that such a measure would likely mitigate market and systemic risk as forewarned FMIs would be placed in a position to prepare settlement and clearing routines in order to minimise adverse market impacts and, in the worst case, to absorb losses in a coherent and prepared manner.

If resolution action is required, recovery action has, by definition, either not been taken or has been ineffective. It is therefore of paramount importance to identify the appropriate indicators that would act as triggers for recovery action and to maximise the likelihood that such recovery action is effective. In this case and in contrast to what we have said with respect to resolution, the focus in recovery plans should fall on leading indicators.

What loss allocation methods must be available to a resolution authority, and for which types of FMI? Could or should these resolution powers include tear-up, cash calls or a mandatory replenishment of default fund contributions by an FMI's direct participants? Does it make a difference if the losses are from a defaulting member or are made up of other losses (e.g. losses in investments made by the FMI)? In what circumstances, and by what methods, should losses be passed on beyond the direct participants – e.g. to the clients or FMI shareholders – in resolution?

This question seems to relate to the task of resolving a central counterparty to whom the obligations of its members are novated. In the case of an FMI discharging the functions of an (I)CSD, only certain specific risks are typically mutualised. Loss-sharing mechanisms are necessarily related to such specific risks, most commonly the loss of securities held on a collective basis for the benefit of all holders of positions in that security in custody with the (I)CSD. If the loss that triggers a resolution plan is subject to such arrangements, then loss sharing arrangements should certainly be included in the resolution powers. (We note, however, that management could reasonably be expected to have initiated loss-sharing arrangements in the recovery phase). However, the nature of the legal rights of holders in position in securities held with an (I)CSD are usually such that losses of this nature would not be for the account of the (I)CSD itself but for the account of holders directly. This is the case in both Luxembourg and Germany, for example. Exceptions would typically relate to the gross and / or willful negligence of the CSD. Consequently, such a loss event would not normally be expected to impact the solvency of the CSD itself and would not, accordingly, be expected to form part of the resolution powers.

In the case of banking functions discharged by CSDs that are ancillary to settlement, the mutualisation of banking losses may be an appropriate resolution mechanism for certain individual firms in which case, we believe that explicit loss allocation methods should be developed by that firm in advance with its customers. The availability of ex-post methods of loss allocation to the customers of an (I)CSD absent a priori contractual arrangements would, in our view, potentially undermine the credit-worthiness of the FMI and lead to pro-cyclical effects. We underline that CSDs who perform banking operations that are ancillary to

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settlement compete with custodian banks whose depositors and borrowers are protected from the risk of bail-in measures even where the custodian bank in question is a SIFI.

Consideration should also be given to the question of FMIs participating in CSDs who have general loss-sharing or bail-in arrangements in place. Such practices raise numerous issues including the risk of debilitating pro-cyclical effects (the risk of a domino effect) and the very real possibility of competitive abuse. A CSD, for example, which subjects potential FMI participants to general loss sharing or bail-in arrangements establishes, in so-doing, an effective barrier to participation, discouraging interoperability and increasing the costs of cross-border clearing and settlement because such arrangements may be incompatible with the legal and governance regimes of the potential FMI participant. We note that our reservation on this point does not apply to the question of participation in any loss of securities position, since this specific risk is one that the investor CSD would be in a position to pass onto to its own participants.

In conclusion and in respect of CSDs and (I)CSDs, Clearstream believes that in general terms, resolution powers should allocate losses to shareholders and that sufficient capital should be maintained to absorb foreseeable levels of operating loss. If resolution powers nonetheless are to include recovery from participants, arrangements must be contractual and allocation methods agreed between the FMI and its participants a priori and carefully tested to guard against the possibility of competitive abuse.

Important interpretations of the Key Attributes when applied to FMIs

Are there any circumstances in which a moratorium with a suspension of payments to unsecured creditors may be appropriate when resolving an FMI? Should this be limited to certain types of FMI and/or certain types of payment?

Clearstream believes in general that a moratorium or suspension of payments would tend to defeat the purposes of a Recovery Plan for the reasons stated on p.11 of the CPSS-IOSCO Consultative Report of July 2012 in the case of an FMI that is an (I)CSD.

It is necessary to differentiate between payments made by the (I)CSD in the following contexts;-

1. Payments made in respect of cash entitlements in securities deposited with the (I)CSD
2. Payments made in respect of settlements and ancillary deposit taking activity.
3. Payments made by the (I)CSD for its own account

A moratorium on the payment of cash entitlements arising as a result of safekeeping and custody would appear to serve no useful purpose since the objective of a resolution regime is to enable the FMI to continue to perform critical functions and services as expected in a financial crisis. The capacity to transfer entitlements from the issuers of securities to the holders is clearly such a critical function. In the context of a recovery action, such payments

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when collected from issuers and holders must be processed without entering the “*masse en faillite*” of the FMI.

A moratorium in respect of payments associated to settlements in a simple form would fall foul of the same objection; the capacity of the (I)CSD to discharge the critical function of settlement would be compromised. It is of equal importance that any collateral posted by an (I)CSD (collateral re-use) would continue to be available to the collateral-receiver.

We note, however, that if resolution measures result in the transfer of the activity of a failing (I)CSD (to a bridge institution, for example), a suspension of payments of the FMI could potentially be envisaged if provision were made for deposits to be received by and payments to be made to the account of the transferee entity in the same technical system as used by the FMI so that payments activity in respect of the critical functions described above could be continued on account of the transferee. In such a construct, depositors would open new bank accounts whereas they would continue to have access to their securities accounts which do not, in any case, form part of the assets of the FMI in its capacity of a depository or custodian.

In conducting a resolvability assessment of an FMI, what factors should authorities pay particular attention to?

We believe that authorities should pay particular attention to the purpose of resolution planning which should be made very explicit. Our understanding is that the welfare benefit of resolution planning for FMIs is the assurance of continuity of the critical functions provided in the event of insolvency. This benefit should have no bearing on the solvency risk posed by the FMI or on the level of loss that the system as whole will suffer in the event of its insolvency.

It therefore follows that the primary focus of both supervisors and managers should fall on the quality and appropriateness of the FMI's risk management, profile and governance. For this reason, we believe that recovery planning (as distinct from resolution planning) must play a central role in the risk management frameworks of FMIs.

A second consideration is the compatibility of resolution plans with insolvency law, the purpose of which will in most jurisdictions be to maximise the recovery rate of creditors. Resolution planning implies, at least in principle, that those interests may be subordinated to the principle of continuity. Consequently, the development of resolution plans must be accompanied by a degree of insolvency reform.

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Specific considerations to the questions raised in the consultative report

Q1: In what circumstances and for what types of FMI can a statutory management, administration or conservatorship offer an appropriate process within which to ensure a continuity of critical services?

Resolution plans must be specific on the identity of the conservatorship that would replace the board of the FMI in resolution in circumstances where this would be an appropriate step. A priori clarity is essential on this point.

Resolution plans should also be specific to the kind of FMI in question and should be adapted to its specific situation and the markets and clients that it serves. Flexibility on this point would be appropriate.

Whilst Recovery Plans can be triggered by a wide array of leading indicators, Resolution Plans should be triggered only by the insolvency of the FMI or the imminent and evident risk of impending insolvency.

Once triggered a Resolution Plan would in principle benefit from a conservatorship in circumstances where new capital is to be injected by a party other than the shareholders with the objective of restoring the FMI to solvency or where the critical functions of the FMI were to be transferred in order to ensure their continuity.

Q2: Are there powers beyond those of a standard insolvency practitioner that a statutory manager, administrator or conservator would require in these circumstances?

Given that the primary objective of the conservator or equivalent administrator of an FMI would be first to ensure the continuity of the critical functions of the FMI and only second to protect the interests of creditors, the powers of a statutory insolvency practitioner would in principle be insufficient to manage a situation where these two goals were in conflict.

Q3: Is tear-up an appropriate loss allocation arrangement prior to resolution of a CCP? If so, in what circumstances?

Clearstream's responses are restricted to FMIs acting as (I)CSDs.

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Q4: To what extent should the possibility of a tear-up in recovery be articulated in ex ante rules?

Clearstream's responses are restricted to FMIs acting as (I)CSDs.

Q5: Should there be a limit to the number of contracts that are eligible for tear-up?

Clearstream's responses are restricted to FMIs acting as (I)CSDs.

Q6: How should the appropriate haircuts be determined?

Clearstream's responses are restricted to FMIs acting as (I)CSDs.

Q7: What qualitative or quantitative indicators of non-viability should be used in determining the trigger for resolution for different types of FMI?

Resolution Plans should be triggered only by the insolvency of the FMI or the imminent and evident risk of its impending insolvency. As we argue above, this is necessary to maintain the credit-worthiness of solvent FMIs, to protect the legitimate interests of depositors and shareholders and to minimise pro-cyclical effects. It is also necessary to shield FMIs, their owners and customers from arbitrary action.

Recovery plans, on the other hand, should seek to define leading indicators of potential non-viability which, inter alia, should aim to provide the resolution authorities with the necessary transparency to monitor the solvency of an FMI in recovery on a continuous basis. In the case of (I)CSDs, such indicators should relate both to the solvency and to the liquidity of the FMI as well as its capacity to bear fat tail operating losses. Indicators should not be blind. For example, exhausting a liquidity buffer may be a valid indicator that recovery action is necessary in most scenarios, but there are others where it may not be; for example, a prolonged outage of the national payment system. Lastly, indicators must be adapted to the functions of the FMI in question; indicators that are valid for a CCP may not be relevant for a CSD and must include at least some indicators which are specific to the risk profile and business model of the FMI itself.

Q8: What loss allocation methods must be available to a resolution authority, and for which types of FMI? Could or should these resolution powers include tear-up, cash calls or a mandatory replenishment of default fund contributions by an FMI's direct participants? Does it make a difference if the losses are from a defaulting member or are made up of other losses (e.g. losses in investments made by the FMI)? In what circumstances, and by what methods,

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should losses be passed on beyond the direct participants – e.g. to the clients or FMI shareholders – in resolution?

Please see our response to section B above.

Q9: What, if any, special considerations or methods should be applied when allocating losses whose maximum value cannot be capped (e.g. when allocating potential losses that might arise from open and uncapped positions at a CCP)?

Clearstream's responses are restricted to FMIs acting as (I)CSDs.

Q10: How should equity in FMIs be treated in resolution scenarios: should it be written down in all circumstances?

In principle and subject to the proviso that resolution action can be triggered only by the insolvency of the FMI, the capacity to write down equity should be available to the authority. It is conceivable, however, that the objective of ensuring the continuity of the FMI's critical functions might in specific scenarios be best served by maintaining a level of equity and withholding this from creditors. The experience of enterprises subject to Chapter 11 regimes in the United States offer examples of this. In such circumstances, the authority should be expected to show that it has reasonable grounds for believing that equity can be restored through the continuation of operations.

Q11: Are there circumstances in which loss allocation in resolution should result in a different distribution of losses to losses borne in insolvency? Does it make a difference if the losses stem from a defaulting member or are made up of other losses (e.g. losses in investments made by the FMI or resulting from operational risks)?

It seems to us that it is axiomatic that there would be. If the loss-allocation principles applied under normal insolvency regimes would in all cases ensure the continuity of critical functions, then resolution planning would be redundant. Under normal insolvency principles, if the interests of the creditors were best served by ceasing operations and liquidating the means of production, then clearly that is what the liquidator must do. In the case of the insolvency of an FMI, the priorities of the administration would be different in relation to functions deemed to be systemically critical and hence both the amount of creditor losses and their distribution would potentially differ from those that would arise under a normal insolvency regime. .

The second part of the question relates to CCPs and Clearstream's responses are restricted to FMIs acting as (I)CSDs.

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Q12: Should an FMI's rules for addressing uncovered losses be taken into account when calculating whether creditors are no worse off in resolution than in liquidation?

From our point of view, it is impossible to define ex-ante, or even ex-post, in what form of recovery or resolution what kind of creditors would be worse off than in liquidation. We are of the view that the resolution authority should proceed in the reasonable belief that this is likely to be the result of its actions.

Q13: Are there any circumstances in which the ability to exercise termination rights as a result of the use of resolution powers should outweigh the objective of ensuring continuity?

Ultimately, the interests of creditors must be balanced against those of the objective of ensuring continuity. As a general observation, resolution powers should include the ability to novate some but not all contractual rights and obligations of the FMI whilst terminating others. This is a consideration that arises, for example, when considering the use of a bridge institution of when transferring the functions of the FMI. Particular importance needs to be attached to the question of whether any contractual arrangements of the FMI must foresee the possibility of novation a priori.

Q14: Are there any circumstances in which a temporary stay on exercising termination rights should apply for any event of default and not just where triggered by the resolution measures?

Clearstream's responses are restricted to FMIs acting as (I)CSDs in which context default.

Q15: Are there any circumstances in which a moratorium with a suspension of payments to unsecured creditors may be appropriate when resolving an FMI? Should this be limited to certain types of FMI and/or certain types of payment?

Please see our response under section B above.

Q16: If so, should resolution authorities retain the discretion to apply a moratorium and, if so, what restrictions (if any) on its use would be appropriate (e.g. scope, duration or purpose)?

Discretion would necessarily be required in our view. In addition, any suspension must be time limited. It must have a specific objective and be supported by a specific strategy. It must also be subject to the authority's having reasonable grounds for believing that the creditors' losses will not ultimately be enlarged by the moratorium.

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Q17: Should the bail-in tool be available to collateral, margin (including initial margin) and other sources of funds if they would bear losses in insolvency?

Clearstream's responses are restricted to FMIs acting as (I)CSDs.

Q18: In what circumstances and for what types of FMI should wider loss recovery arrangements exist beyond the FMI's own rules and the resolution powers of the resolution authority?

Clearstream's responses are restricted to FMIs acting as (I)CSDs.

Q19: In conducting a resolvability assessment of an FMI, what factors should authorities pay particular attention to?

Please see our earlier responses.